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Officials Worry As Crypto Boom Invades Banking

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Body

BlockFi, a fast-growing financial start-up whose headquarters in Jersey City are across the Hudson River from Wall Street, aspires to be the JPMorgan Chase of cryptocurrency.

It offers credit cards, loans and interest-generating accounts. But rather than dealing primarily in dollars, BlockFi operates in the rapidly expanding world of digital currencies, one of a new generation of institutions effectively creating an alternative banking system on the frontiers of technology.

"We are just at the beginning of this story," said Flori Marquez, 30, a founder of BlockFi, which was created in 2017 and claims to have more than $10 billion in assets, 850 employees and more than 450,000 retail clients who can obtain loans in minutes, without credit checks.

But to state and federal regulators and some members of Congress, the entry of crypto into banking is cause for alarm. The technology is disrupting the world of financial services so quickly and unpredictably that regulators are far behind, potentially leaving consumers and financial markets vulnerable.

In recent months, top officials from the Federal Reserve and other banking regulators have urgently begun what they are calling a "crypto sprint" to try to catch up with the rapid changes and figure out how to curb the potential dangers from an emerging industry whose short history has been marked as much by high-stakes speculation as by technological advances.

In interviews and public statements, federal officials and state authorities are warning that the crypto financial services industry is in some cases vulnerable to hackers and fraud and reliant on risky innovations. Last month, the crypto platform PolyNetwork briefly lost $600 million of its customers' assets to hackers, much of which was returned only after the site's founders begged the thieves to relent.

"We need additional authorities to prevent transactions, products and platforms from falling between regulatory cracks," Gary Gensler, the chairman of the Securities and Exchange Commission, wrote in August in a letter to Senator Elizabeth Warren, Democrat of Massachusetts, about the dangers of cryptocurrency products. "We also need more resources to protect investors in this growing and volatile sector."

The S.E.C. has created a stand-alone office to coordinate investigations into cryptocurrency and other digital assets, and it has recruited academics with related expertise to help it track the fast-moving changes. Acknowledging that it could take at least a year to write rules or get legislation passed in Congress, regulators may issue interim guidance to set some expectations to exert control over the industry.

BlockFi has already been targeted by regulators in five states that have accused it of violating local securities laws.

Regulators' worries reach to even more experimental offerings by outfits like PancakeSwap, whose "syrup pools" boast that users can earn up to 91 percent annual return on crypto deposits.

Treasury Secretary Janet L. Yellen and Jerome H. Powell, the chair of the Federal Reserve, have also voiced concerns, even as the Fed and other central banks study whether to issue digital currencies of their own.

Mr. Powell has pointed to the proliferation of so-called stablecoins, digital currencies whose value is typically pegged to the dollar and are frequently used in digital money transfers and other transactions like lending.

"We have a tradition in this country where, you know, where the public's money is held in what is supposed to be a very safe asset," Mr. Powell said during congressional testimony in July, adding, "That doesn't exist really for stablecoins."

The cryptocurrency banking frontier features a wide range of companies. At one end are those that operate on models similar to those of traditional consumer-oriented banks, like BlockFi or Kraken Bank, which has secured a special charter in Wyoming and hopes by the end of this year to take consumers' ***cryptocurrency*** deposits -- but without traditional Federal Deposit Insurance Corporation insurance.

On the more radical end is decentralized finance, or DeFi, which is more akin to Wall Street for ***cryptocurrency***. Players include Compound, a company in San Francisco that operates completely outside the regulatory system. DeFi eliminates human intermediaries like brokers, bank clerks and traders, and instead uses algorithms to execute financial transactions, such as lending and borrowing.

"Crypto is the new ***shadow bank***," Ms. Warren said in an interview. "It provides many of the same services, but without the consumer protections or financial stability that back up the traditional system."

"It's like spinning straw into gold," she added.

Lawmakers and regulators are worried that consumers are not always fully aware of the potential dangers of the new banklike crypto services and decentralized finance platforms. Crypto deposit accounts are not federally insured and holdings may not be guaranteed if markets go haywire.

People who borrow against their crypto could face liquidation of their holdings, sometimes in entirely automated markets that are unregulated.

From Pawnbroker to Bank

BlockFi's extraordinary growth -- and the recent crackdown by state regulators -- illustrates the fraught path of cryptocurrency financial services companies amid confusion about what they do.

BlockFi's business is not dissimilar to that of a regular bank. It takes deposits of cryptocurrencies and pays interest on them. It makes loans in dollars to people who put up cryptocurrency as collateral. And it lends crypto to institutions that need it.

For consumers, the main allure of BlockFi is the chance to take loans in dollars up to half of the value of their crypto collateral, allowing customers to get cash without the tax hit of selling their digital assets, or to leverage the value of holdings to buy more cryptocurrency. The company also offers interest of up to 8 percent per year on crypto deposits, compared with a national average of 0.06 percent for savings deposits at banks in August.

How can BlockFi offer such a high rate? In addition to charging interest on the loans it makes to consumers, it lends cryptocurrency to institutions like Fidelity Investments or Susquehanna International Group that use those assets for quick and sometimes lucrative cryptocurrency arbitrage transactions, passing on high returns to customers. And because BlockFi is not officially a bank, it does not have the large costs associated with maintaining required capital reserves and following other banking regulations.

Also unlike a bank, BlockFi does not check credit scores, relying instead on the value of customers' underlying crypto collateral. The company's executives argue that the approach democratizes financial services, opening them to people without the traditional hallmarks of reliability -- like good credit -- but with digital assets.

The model has worked for BlockFi. It is hiring employees from London to Singapore, while prominent investors -- like Bain Capital, Winklevoss Capital and Coinbase Ventures -- have jumped in to fund its expansion. The company has raised at least $450 million in capital.

But to regulators, BlockFi's offerings are worrying and perplexing -- so much so that in California, where BlockFi first sought a lender's license, officials initially advised it to instead apply for a pawnbroker license. Their reasoning was that customers seeking a loan from BlockFi hand over cryptocurrency holdings as collateral in the same way that a customer might give a pawnshop a watch in exchange for cash.

Ms. Marquez of BlockFi called the sheriff's office in San Francisco about a pawnbroker license, only to be redirected again. ''No, pawnbrokers' licenses are only for physical goods,'' she recounted being told. ''And because crypto is a virtual asset, this license actually does not apply to you.''

Undeterred, she returned to the state's banking regulators and persuaded them BlockFi qualified as a lender, albeit of a new variety. The company now has licenses in at least 28 states, which it uses for cryptocurrency deposits from its more than 450,000 clients -- many of whom are outside the United States. In the first three months of this year, the value of crypto held in BlockFi interest-bearing accounts more than tripled to $14.7 billion from $4.4 billion, a jump driven in part by the rise in the price of Bitcoin and other cryptocurrencies.

As the company has expanded, regulators have become increasingly concerned. New Jersey's attorney general sent it a ''cease and desist'' letter in July, saying it sells a financial product that requires a securities license, with all the associated obligations, including mandated disclosures.

''No one gets a free pass simply because they're operating in the fast-evolving cryptocurrency market,'' the acting attorney general, Andrew J. Bruck, said.

BlockFi does not adequately notify customers of risks associated with its use of their cryptocurrency deposits for borrowing pools, including the ''creditworthiness of borrowers, the type and nature of transactions,'' officials in Texas added in their own complaint, echoing allegations made by state officials in Alabama, Kentucky and Vermont.

Zac Prince, BlockFi's chief executive, said that the company was complying with the law but that regulators did not fully understand its offerings. ''Ultimately, we see this as an opportunity for BlockFi to help define the regulatory environment for our ecosystem,'' he wrote in a note to customers.

Breaking the Banking Mold

The regulatory challenge is even greater when it comes to other emerging crypto finance developers in the world of DeFi, such as Compound, SushiSwap and Aave as well as PancakeSwap.

They are all essentially automated markets run by computer programs facilitating transactions without human intervention -- the crypto-era version of trading floors. The idea is to eliminate intermediaries and bring together buyers and sellers on the blockchain, the technology behind cryptocurrency. The sites do not even collect users' personal information.

Founders of those kinds of platforms argue that they are just building a ''protocol'' ultimately led by a community of users, with the computer code effectively running the show.

Robert Leshner, 37, started Compound in 2018 after spending a year in a tiny attic office sublet in the Mission district in San Francisco with five colleagues, experimenting with a computer program that would become part of the foundation of the DeFi movement.

Compound -- backed by prominent crypto venture capitalists like Andreessen Horowitz and Coinbase Ventures -- now has more than $20 billion in assets. Each of the nearly 300,000 "customers" is represented by a unique 42-character list of letters and numbers. But Compound does not know their names or even what country they are from.

Mr. Leshner and others who helped set up Compound own a large share of its self-issued cryptocurrency token -- known as COMP -- which has surged in value, making him worth, at least on paper, tens of millions of dollars.

Mr. Leshner has been startled by the rapid growth. "At every juncture, the speed at which decentralized finance has just, like, started to work, has caught myself and everybody off guard," he said.

Industry executives say concerns about the safety and stability of digital assets are overblown, but federal financial regulators are still working to get a handle on the latest developments.

DeFi protocols largely rely upon stablecoins, cryptocurrencies that are ostensibly pegged to the United States dollar for a steady value but without guarantees that their value is adequately backed.

The overall market of stablecoins has ballooned to $117 billion as of early September from $3.3 billion in January 2019. That has regulators worried.

"These things are effectively treated by users as bank deposits," said Lee Reiners, a former supervisor at the Federal Reserve Bank of New York. "But unlike actual deposits, they are not insured by F.D.I.C., and if account holders begin to have concerns that they cannot get money out, they might try and trigger a bank run."

One option worth considering, Ms. Warren said, is to ban banks in the United States from holding cash deposits backing up stablecoins, which could effectively end the surging market. Another possibility that some say could undermine the entire crypto ecosystem is the creation of a government-issued digital dollar.

"You wouldn't need stablecoins, you wouldn't need cryptocurrencies if you had a digital U.S. currency," Mr. Powell, the Fed chairman, said in July. "I think that's one of the stronger arguments in its favor."

https://www.nytimes.com/2021/09/05/us/politics/cryptocurrency-banking-regulation.html

Graphic

PHOTO: (PHOTOGRAPH BY Dalbert B. Vilarino FOR THE NEW YORK TIMES)

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